95-909

No.

Supreme Court, U.S.
FILED
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IN THE

Supreme Court of the United States

OCTOBER TERM, 1995

KOCH OIL COMPANY,

Petitioner,

v.

COMMITTEE OF CREDITORS HOLDING UNSECURED CLAIMS AGAINST POWERINE OIL COMPANY, DEBTOR IN BANKRUPTCY,

Respondent.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

PETITION FOR WRIT OF CERTIORARI

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29 pp

QUESTIONS PRESENTED

1. In determining for purposes of § 547(b)(5) of the Bankruptcy Code whether a transfer enabled a creditor to receive more than such a creditor would have received in a liquidation of the transferor's assets under chapter 7 of the Code, must a court disregard the fact that the transferee was the beneficiary of an irrevocable standby letter of credit issued by the transferor's bank which the transferee would have drawn down in the amount of the transfer had the transfer not occurred?

2. Is it an essential element of a voidable preferential transfer under the Bankruptcy Code that the transfer diminished the amount claimants in the same class as that of the transferee would have received had the transfer not been made?

PARTIES TO THE PROCEEDING AND RULE 29.1 STATEMENT

Petitioner Koch Oil Company has no parent company, subsidiaries or affiliates that have issued shares to the public.

According to a Disclosure Statement filed by Powerine Oil Company in the U.S. Bankruptcy Court for the Central District of California on December 10, 1984, the Respondent Committee of Creditors Holding Unsecured Claims consisted of representatives of the following individuals and entities: Ofcco Construction Co.; Macco Contractors, Inc.; San Diego Pipeline Co.; Crosby & Overton, Inc.; Rau & Rice Enterprises, Inc.; 415 Mid-Continent Tower; Southern Pacific Pipeline Inc.; Peter L. Lacombe; Charles R. Tatum; American Instrument; Union Oil Co. of California, and Kilpatrick, Clayton, Myer & Madden.

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PETITION FOR WRIT OF CERTIORARI

Petitioner Koch Oil Company respectfully prays that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Ninth Circuit entered in the above captioned case on July 12, 1995.

OPINIONS BELOW

The opinion of the Court of Appeals is reported at 59 F.3d 969, 27 Bankr. Ct. Dec. 623, Bankr. L. Rep. p. 76,554 and is reprinted in the appendix hereto ("App.") at A1. The decision of the United States Bankruptcy Appellate Panel for the Ninth Circuit is not reported and

is reprinted at App. B1. The Memorandum of Decision of the United States Bankruptcy Court for the Central District of California is not reported and is reprinted at App. C1. The Findings of Fact and Conclusions of Law adopted by the Bankruptcy Court are not reported and are reprinted at App. D1. The Summary Judgment of the Bankruptcy Court is not reported and is reprinted at App. E1.

JURISDICTION

The Court of Appeals filed its opinion on July 12, 1995. App. A1. That Court denied a timely filed petition for rehearing on September 7, 1995. App. F1. The jurisdiction of this Court rests on 28 U.S.C. § 1254.

PERTINENT STATUTORY PROVISIONS

Pertinent provisions of the Bankruptcy Code of 1978, as amended (11 U.S.C. §§ 101-1330), are set forth at App. G1.

STATEMENT OF THE CASE

In the Ninth Circuit, there are times when a trade creditor can count itself lucky if its customers don't pay their bills. The petitioner in this case, Koch Oil Company, had the dubious honor of being the first to find this out when its customer Powerine Oil Company filed for bankruptcy shortly after paying for 155 thousand barrels of crude oil Koch had delivered to it in preceding weeks.

At various times during the period 1982-1984, Koch entered into contracts to sell crude oil to Powerine (App. D2-D3). Under these contracts, Powerine was to pay Koch for the crude oil on the twentieth day of the month following the month of delivery. (Defendant's Statement of Uncontroverted Facts filed in he Bankruptcy Court on August 1, 1989 [hereinafter cited as "Uncontroverted Facts"]). At Koch's insistence, Powerine secured its obligation to pay Koch by directing the First National Bank of Chicago ("FNBC") to issue two irrevocable standby letters of credit for its account in favor of Koch as beneficiary (Uncontroverted Facts, ¶ 1). The first of these letters of credit was issued on December 27, 1982. Addressed to Koch "by the order of Powerine Oil Co.", it stated:

> We hereby issue in your favor our irrevocable credit for the account of Powerine Oil Co. for an amount or amounts not to exceed in the aggregate US Dollars 3,596,000.00 (Three Million Five Hundred Ninety Six Thousand and No/100 US Dollars) available by your drafts on The First National Bank of Chicago, Chicago, IL, U.S.A. effective December 27, 1982 and expiring at our office on February 28, 1983.

(Uncontroverted Facts, ¶ 1, Gr. Ex. 1).

This letter of credit subsequently was amended at various times at Powerine's request to extend the expiration date of the letter or the amount of the letter. As finally amended, the expiration date was April 30, 1984 and the amount was $7,074,620. (Uncontroverted Facts, ¶ 1, Gr. Ex. 1). The second letter of credit was issued on July 20, 1983 in essentially the same form. It advised Koch that:

> We hereby issue in your favor our irrevocable credit for the account of Powerine Oil Co. for an amount or

> amounts not to exceed in the aggregate US Dollars 837,000.00 (Eight Hundred Thirty Seven Thousand and No/100 US Dollars) available by your drafts at sight on The First National Bank of Chicago, Chicago, IL. U.S.A. effective July 20, 1983 and expiring at our office on September 30, 1983.

(Uncontroverted Facts, ¶ 1, Gr. Ex. 1). The second letter of credit also subsequently was amended to change its expiration date to April 30, 1984 and its amount to $1,674,000. (*Id.*).

If Powerine failed to make timely payment, Koch could collect the amount of the payments from the FNBC by presenting to the bank, prior to the expiration date of the letters of credit, the commercial invoices for the product delivered and a statement certifying that the invoices were unpaid as of their due dates and that Koch held legal title to the crude oil prior to transferring such title to Powerine. (Uncontroverted Facts, ¶ 1, Gr. Ex. 1).

As consideration for issuing the letters of credit, the FNBC required Powerine to enter into security agreements for the benefit of the bank. The first of these agreements provided, in pertinent part, that Powerine would reimburse the bank at its demand for any amount the bank paid on drafts or drawings, or pay the bank in advance any amount required to pay such drafts or drawings; that "each amount which may become due and payable to you under this Agreement may, in your discretion, and if not otherwise paid, be charged by you to any available funds then held by you for our account," and that:

> all property . . . in which any of us may have an interest, of every name and nature whatsoever, now or at any time hereafter delivered, conveyed, trans-

> ferred, assigned, or paid to you, or coming into your possession in any manner whatsoever, whether expressly as security for any of our obligations or liabilities to you, or for safekeeping or otherwise, including any items received for collection or transmission and the proceeds thereof, whether or not such property is in whole or in part released to us on security agreement, is hereby made security for each and all such obligations and liabilities.

(Uncontroverted Facts, ¶ 2, Gr. Ex. 1). The wording of the agreement securing the second letter of credit was essentially the same. (*Id.*).

These were not the only security agreements Powerine had entered into with the FNBC. Some 20 months before issuance of the first letter of credit, Powerine had entered into an agreement with a trust organized for the benefit of a syndicate of several insurance companies and banking institutions, including the FNBC, to secure a $250.6 million line of credit. Under this agreement, Powerine assigned the trustee a security interest in most of its personal property:

> . . . for the purpose of securing equally without preference or priority of any one over the other:
>
> A. Payment of the indebtedness evidenced by the Bank Notes and the Insurance Company Notes (collectively, the "Notes");
>
> B. Payment of obligations of Debtor to any one or more of the Banks under applications for letters of credit under which letters of credit have been, or are in the future, issued on the account of Debtor in favor of vendors of crude oil sold to Debtor.

(Uncontroverted Facts, Ex. 2).

Prior to March of 1984, Powerine had always made timely payment, including two payments—each for more than $4 million, that fell due within the 90 days preceding the filing of Powerine's chapter 11 bankruptcy petition on March 26, 1984).[1] Powerine made these two payments by instructing the FNBC to make wire transfers from Powerine's checking account to Koch's account at the FNBC. (App. D4) To permit the transfers, the FNBC released its security interest in the funds in the checking account (App. D4; Uncontroverted Facts, ¶ 4).

The two letters of credit expired by their terms on April 30, 1984. On March 25, 1986, Respondent Committee of Creditors Holding Unsecured Claims commenced an adversary proceeding against Koch seeking to set aside the two payments Powerine made to Koch within the 90 days preceding bankruptcy as preferences under Bankruptcy Code § 547(b).[2] (App. A5; Complaint ¶¶ 5-11). It was undisputed that if Powerine had not paid, Koch would have been paid in full by the letters of credit.

The Bankruptcy Court rejected Respondent's claim on the ground that, because the FNBC permitted the payments to be made out of a Powerine checking account in which the bank held a security interest, the payments fell within the Code § 547(c)(1) exception for transfers

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[1] Powerine failed to make a payment of over $4 million due in the same month it filed its petition and Koch drew down the letters of credit in a corresponding amount. The FNBC then debited Powerine's checking account in that amount pursuant to its rights under the agreements securing the letters of credit. (App. B3-B4).

[2] Respondent initially contended that the entire $8,550,990.70 paid was preferential but subsequently acknowledged that over $5 million of that amount was insulated by the "ordinary course of business" defense of Code § 547(c)(2).

that were contemporaneous exchanges for new value. (App. C2).

The Bankruptcy Appellate Panel disagreed with the Bankruptcy Court's analysis to a certain extent. Observing that the debtor's obligation to reimburse FNBC in the event the bank paid on the letters of credit was undersecured, the BAP concluded that the § 547(c)(1) exception to avoidability only protected the transfers in an amount equal to the amount of the released checking account funds that represented security for the bank's obligations on the letters of credit. (App. B9-B10).

The BAP went on to hold, however, that the portion of the payments with respect to which the Bank's letter of credit obligations was unsecured did not constitute a preference because it did not satisfy the requirement of Code § 547(b)(5) that the transfer enable the creditor to receive more than it would receive if the transfer had not taken place and the debtor's estate was liquidated under chapter 7 of the Code. (App. B12). Koch did not receive more than it would have received, the BAP reasoned, because if Powerine had not paid, Koch would have drawn down the letters of credit. Noting that "avoidance of a preferential transfer is purposed upon placing the estate and its creditors in the same position they would occupy had no transfer been made" (App. B15), the BAP concluded that disregarding the fact that Koch would have drawn down the letters of credit had Powerine not paid would frustrate the intent of the preference provisions of the Code and was not required by the language of the statute.

The Court of Appeals reversed, ruling that in making the comparison with an hypothetical chapter 7 distribution required by § 547(b)(5), the statutory language pro-

vided no basis for taking into consideration Koch's right to draw on letters of credit in deciding whether Koch received a preference. (App. A9). Although the Court of Appeals viewed the BAP's decision as an attempt to exercise equitable power to avoid an unjust result, it stated that equity may not be invoked to defeat clear statutory language nor to reach results inconsistent with the statutory scheme established by the Code. (App. A8). Treating Koch as an unsecured creditor of Powerine, the Court of Appeals concluded that, since it was evident that unsecured creditors would not have received 100 cents on the dollar in a chapter 7 liquidation, the transfers to Koch met the test of § 547(b)(5). (App. A7).[3]

REASONS FOR GRANTING THE WRIT

I.

The Court of Appeals incorrectly interpreted and incorrectly applied Bankruptcy Code § 547(b)(5) in this case. Both the Court of Appeals and the Bankruptcy Appellate Panel struggled in interpreting § 547(b)(5) and ended up reaching opposite conclusions through differing analyses. Neither court's ruling was unanimous, and the Court of Appeals' majority opinion seemed to recognize that its ruling was contrary to common sense when it observed that "[l]aw can be stranger than fiction in the Preference

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[3] The Court of Appeals agreed with the BAP that, since the FNBC was undersecured, only the secured portion of its contingent reimbursement claim against the estate was released by Powerine's payment and only to that extent was the transfer to Koch protected by the contemporaneous exchange for new value rule of Code § 547(c)(1). (App. A10). The Court remanded the case to the Bankruptcy Court for determination of what portion of the debt was secured. (App. A11).

Zone." (App. A4). The new meaning given the Code by the Court of Appeals will effectively destroy the commercial usefulness of standby letters of credit and extend the scope of the preferential transfer rules of the Bankruptcy Code to encompass transactions not heretofore considered "preferential".

Although the Court of Appeals acknowledged it must be guided by "clear statutory language" and must reach a result consistent "with the statutory scheme established by the Code," (App. A9), its opinion violated these precepts. The court's prescription for how to determine whether a payment of a debt secured by standby letters of credit meets the test of § 547(b)(5) flies in the face of the intent of the preference provisions of the Code because it ignores the requirement that to be preferential a transfer must result in a diminution of the bankrupt's estate. Thus, the Court of Appeals engaged in a form of statutory construction often cautioned against by this Court.[4]

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[4] It is axiomatic that the parts of a statute are to be interpreted in the context of the meaning and policy objectives of the entire legislative expression. A statute is passed as a whole and is animated by one general purpose and intent. Courts will not only consider the particular provision in question, but the entire legislative scheme. *See Kelly v. Robinson*, 479 U.S. 36, 43 (1986), citing *Offshore Logistics, Inc. v. Tallentire*, 477 U.S. 207, 222 (1986). *See, also, Tigr Restaurant, Inc. v. Rouse S.I. Shopping Center, Inc.*, 79 B.R. 954 (E.D. N.Y. 1987); *In re Sokolsky*, 18 B.R. 138 (M.D. Fla. 1982). The Bankruptcy Code should not be interpreted to erode past bankruptcy principles absent an indication of clear congressional intent to do so. *Dewsnup v. Timm*, 502 U.S. 410 (1992); *Pennsylvania Dept. of Public Welfare v. Davenport*, 495 U.S. 552 (1990); *In re Bonner Mall Partnership*, 2 F.3d 899, 913 (9th Cir. 1993).

The *sine qua non* of a voidable preference is that the transfer alleged to be preferential resulted in a diminution of the bankrupt's estate. *If the transfer did not reduce the amount that creditors otherwise would have received, there is no preference.* Diminution of the bankrupt estate is an "essential element of a preferential transfer within the meaning of the Bankruptcy Act". *Continental & Commercial Trust & Savings Bank v. Chicago Title & Trust Co.*, 229 U.S. 435, 444 (1913).

> To constitute a preferential transfer within the meaning of the Bankruptcy Act there must be a parting with the bankrupt's property for the benefit of the creditor *and a consequent diminution of the bankrupt's estate. New York County National Bank v. Massey,* 192 U.S. 138, 147; *Newport Bank v. Herkimer Bank*, 225 U.S. 178, 184.

Id. at 443 (emphasis added). After concluding in the *Continental & Commercial Trust* case that the essential element of diminution was missing from the transaction, this Court noted:

> The fact that what was done worked to the benefit of the creditor and in a sense gave him a preference is not enough, unless the estate of the bankrupt was thereby diminished.

Id. at 444.

Congress has not departed from that fundamental principle in the years since this ruling. The measure of the value of a voidable preference continues to be diminution of the debtor's estate, not the value of the transfer to the creditor. *See Virginia Nat. Bank v. Woodson*, 329 F.2d 836, 840 (4th Cir. 1964) ("The test is not what the creditor receives, but what the bankrupt's estate has lost. It is the diminution of the bankrupt's estate, not the unequal payment to creditors, which is the evil sought to be

remedied by the avoidance of a preferential transfer."); *Palmer v. Radio Corp. of America*, 453 F.2d 1133, 1135 (5th Cir. 1971) ("Even though not expressly provided by [the Bankruptcy Act] it is implicit from the language used that the transfer must result in a diminution of the bankrupt estate."); *In re Metro Communications, Inc.* 115 B.R. 849, 856 (W.D. Pa. 1990). *Cf. Gillman v. Chase Manhattan Bank,* 537 N.Y.S.2d 787, 795-96 (Ct.App. 1988). *See, also, In re Kemp Pacific Fisheries, Inc.*, 16 F.3d 313 (9th Cir. 1994); *Pine Top Insurance Co. v. Bank of America Nat'l Tr. & Sav. Ass'n,* 969 F.2d 321, 329 (7th Cir. 1992); *In re California Trade Technical Schools, Inc.*, 923 F.2d 641, 645 (9th Cir. 1991); *Matter of Holiday Airlines Corp.*, 647 F.2d 977 (9th Cir. 1981); *Matter of Southmark Corp.*, 49 F.3d 1111 (5th Cir. 1995); *In re Interior Wood Products Co.*, 986 F.2d 228 (8th Cir. 1993); *In re Montgomery*, 983 F.2d 1389 (6th Cir. 1993); *Matter of Compton Corp.*, 831 F.2d 586, 593 (5th Cir. 1987); *Deel Rent-A-Car, Inc. v. Levine*, 721 F.2d 750 (11th Cir. 1983). *Cf. In re E.R. Fegert, Inc.*, 887 F.2d 955, 959 (9th Cir. 1989); *Matter of Fuel Oil Supply & Terminaling, Inc.*, 837 F.2d 224, 227-228 (5th Cir. 1988). *But see In re Bergner,* 1995 WL 566128 (Bankr. E.D. Wis) *6-*7 (venturing an opinion that, for purposes of preference analysis, "transfer" and "diminution" are correlative concepts).

The Court of Appeals made no effort to determine whether this essential element of a preference was present in the case of the Powerine/Koch transfers, apparently assuming that diminution invariably occurs in the case of transfers to unsecured creditors of an insolvent debtor. The arbitrary result of this decision, the first to interpret the Code in this particular respect, is doomed to be repeated by any court that embraces the Court of Appeal's reading of § 547(b)(5).

Code § 547(b)(5) provides that, except as provided in subsection (c) of the section, a trustee "may avoid any transfer of interest of the debtor in property" that enables a creditor to receive more than such creditor would receive if: the case were a case under chapter 7 of the Code, "the transfer had not been made" and "such creditor received payment of such debt to the extent provided by the provisions of this title." This test requires determination of how much the members of the transferee's class (in this case, the unsecured creditors) would have received on their claims had the transfer not been made. COLLIER ON BANKRUPTCY ¶ 547.08, at p. 547-45 (15th Ed. 1995). To properly apply § 547(b)(5), therefore, a court must determine whether the transfer alleged to be preferential reduced the amount an unsecured creditor would have received in a hypothetical chapter 7 liquidation under a hypothetical alternative set of facts.[5]

In the § 547(b)(5) "alternative reality" of this case, Koch would have drawn down the letters of credit when Powerine did not pay. To ignore, as the Court of Appeals did, the fact that Koch was the beneficiary of the letters of credit and that Powerine's failure to make the payments would have triggered changes in the secured and unsecured claims against the estate, renders the hypothetical comparison useless insofar as achieving the

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[5] There are three ways in which the amount of an unsecured creditor's distribution could be affected: by *increasing* or *decreasing* the total assets of the estate; by increasing or decreasing the *number* of unsecured claims against the estate; by increasing or decreasing the *amount* of some of the unsecured claims. The effect of a change in any one of these variables cannot be assumed unless the others remain constant. Therefore, a valid hypothetical comparison necessarily requires accounting for each of these variables.

equitable distribution goals of the bankruptcy laws is concerned.

To accurately hypothesize the consequences of the chain of events that would have been set in motion by Powerine's failure to pay, it was necessary for the Court of Appeals to identify the bundle of rights and liabilities defining the tripartite letter of credit relationship between Koch, FCNB and Powerine. The Court made no effort to do that in this case. Had the Court done so, it would have been compelled to take into account the fact that ownership interests in the funds used to pay Koch were transferred to the bank and Koch prior to the payments, in transactions that were not voidable under § 547.[6]

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[6] In the bankruptcy law context, these transfers occurred at the time Powerine granted security interests in its property to secure the letters of credit. When a standby letter of credit is issued, two transfers of the debtor's property occur. The debtor's pledge of its assets to secure the letter of credit is a direct transfer of the debtor's property to the bank and an indirect transfer to the beneficiary of the letters of credit. *In re Air Conditioning, Inc. of Stuart*, 845 F.2d 293, 296 (11th Cir. 1988); *Matter of Compton Corp.*, 831 F.2d 586, 590-591 (5th Cir. 1987). *In re Page*, 18 B.R. 713, 716 (D.C. 1982); *Matter of Planes, Inc.*, 29 B.R. 370 (N.D. Ga. 1983). From the moment a letter of credit is issued, the issuing bank has a present claim against the debtor for reimbursement, contingent upon the bank actually paying the beneficiary pursuant to a draw down. This claim becomes fixed upon occurrence of the contingency. *In re Briggs Transp. Co.*, 37 B.R. 76, 79 (D. Minn. 1984).

Each of these transfers is a contemporaneous exchange for new value. In exchange for the transfer to the issuing bank, the debtor received the bank's promise to pay on the letter of credit; in exchange for the transfer to the beneficiary, the debtor received the extension of credit by the beneficiary. *See Matter of Compton Corp., supra*, at 595. In the instant case,

(continued...)

Contrary to the Court of Appeals' opinion, a pre-petition payment by an insolvent debtor of an unsecured debt does not invariably result in a reduction of the amount the other unsecured creditors would receive in a chapter 7 liquidation of the debtor's estate. There are cases where the nature of the transfer itself precludes a finding of such preferential effect. *See* NORTON BANKRUPTCY LAW AND PRACTICE 2d, § 57:9 pp. 57-40 to 57-41 (1994).

The Court of Appeals failed to recognize Powerine's payments to Koch were such "transfers". The beneficiary of a letter of credit, although an unsecured creditor, differs in a crucial respect from an ordinary general creditor, in that the beneficiary bargained for special treatment before the 90-day preference period, just as a party that secures its debt does.

> [U]nder a letter of credit, the beneficiary is ultimately paid regardless of the actions of the debtor. If the debtor defaults the beneficiary is paid through the letter of credit. If not, the beneficiary is paid in the ordinary course of the underlying commercial transaction. The debtor can choose how the creditor is paid, but it cannot determine whether it is paid. Thus, no act of the debtor during the ninety-day

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[6] (...continued)

the dates of such transfers were May 29, 1981, December 27, 1982, and July 12, 1983. (May 29, 1981 was the effective date of the security agreement Powerine entered in favor of the syndicate of banks and insurance companies described, *ante,* at p. 5. Such security arrangements for future advances are valid. *In re Page*, 18 B.R. 713, 716 (D.C. 1982), citing G. OSBORNE, MORTGAGES, at 178-201 (2d Ed. 1970); GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY, at 916-46 (1965)).

> period 'prefers' the beneficiary. Like a secured creditor, it is 'preferred' only because of a binding agreement publicly noted in a financing statement prior to the ninety-day period. Such 'preferences' do not offend the policy of the section 547 of preventing last-minute manipulations by the debtor for the benefit of some creditors at the expense of others.

Baird, *Standby Letters of Credit in Bankruptcy*, 49 U. CHI. L. REV. 130, 151 (1982) (footnotes omitted). Funds that a bank requires a debtor to deposit as a condition of the bank's issuing a standby letter of credit to the debtor's creditor, and which the bank allows the debtor to draw upon to pay the creditor, are much like "earmarked" funds, the transfer of which to a creditor does not deplete the debtor's estate:

> A transfer involving depletion of the debtor's estate implies the movement of current value from the debtor to the creditor. In many cases, although property has exchanged hands, close questions arise as to whether a transfer of the debtor's property has occurred. For example, "earmarked" funds, which are never in the debtor's control but are marked by a third party for payment of a particular creditor, are not the debtor's funds and their transfer would not deplete the debtor's estate.

3 NORTON BANKRUPTCY LAW AND PRACTICE 2d, § 57:4 at pp. 57-16 to 57-17 (1994). (footnotes omitted).[7] In such

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[7] Prior to the 1995 revision of Article 5, the Uniform Commercial Code, Section 5-117, treated such funds as earmarked in the context of bank insolvencies, explaining in the Official Comment on that section:

> A bank which issues a letter of credit acts as a principal, not as agent for its customer, and engages its own credit. But the resulting liability is not like that to its depositors,

(continued...)

cases, the funds are not any more available to the unsecured creditors prior to the transfer than they are after the transfer. Those are exactly the facts of the Powerine "transfers". Powerine's checking account with the FNBC secured the letters of credit and the bank released the funds from this account for payment of Koch. In effect, funds were being disbursed to Koch from assets of Powerine that had been transferred to the bank and Koch long before—when the secured letters of credit were issued.

If Powerine had not paid when due, Koch could have drawn down the letters of credit in the full amount of the overdue payments with impunity, either before or after Powerine filed its petition.[8] At the time the bank paid Koch pursuant to the letters of credit, the bank's claim against Powerine's estate for the secured portion of the letters of credit would cease to be contingent and the

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[7] (...continued)

> and the security and indemnity furnished by the customer against it . . . are not like its own investments. . . . The bank's credit is engaged, but it expects to be put in funds by its customer before it makes disbursements, or to be reimbursed immediately afterwards. . . . Only the bank's commission . . . will enter the bank's general assets and join the other backing of its deposit liabilities.

[8] Because an issuing bank's obligation to honor a letter of credit is not estate property. *See In re Air Conditioning, Inc. of Stuart,* 845 F.2d 293 (11th Cir. 1988); *Matter of Compton Corp., supra,* at 589; *In re Metro Communications, Inc.* 115 B.R. 849, 854 (W.D. Pa. 1990); *In re W.L. Mead, Inc.* 42 B.R. 57, 59 (N.D. Oh. 1984); *In Re M.J. Sales & Distributing Co., Inc.*, 25 B.R. 608, 614 (S.D. N.Y. 1982) (relying on *First Nat. Bank v. Phalen*, 62 F.2d 21 (7th Cir. 1932); *In re Zaferis Bros. & Co.*, 67 F.2d 140 (9th Cir. 1933) and *National Bank of Newport v. National Herkimer County Bank of Little Falls*, 225 U.S. 178 (1912)).

bank also would possess an unsecured claim against the estate for the balance of Koch's draw-down. In effect, the bank would be substituted for Koch as an unsecured creditor for the unsecured portion of the letters of credit.[9]

On the other hand, when Powerine paid Koch, the bank's *secured* contingent claim against the estate was extinguished, which reduced the amount of unsecured claims against the estate, *pro tanto*; accordingly, the amount that would have been available for distribution to the unsecured creditors was correspondingly increased. The bank's contingent *unsecured* claim against the estate was also extinguished when Powerine paid Koch, which also increased the estate available for distribution to the creditors represented by Respondent.[10] If there is any doubt that this was a "transfer" to Koch without impact on the unsecured creditors, consider what would have happened if the bank had refused to release its lien on the checking account. Since Powerine possessed no unencumbered funds that it could have used to pay Koch, Powerine would have defaulted, Koch would have drawn down the letters of credit and the bank would have reimbursed itself out of the checking account, just as it did when Powerine defaulted on its March 1984 payment to Koch.

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[9] Exchanging one unsecured creditor for another does not create any kind of preference. *Matter of Compton Corp.*, *supra*, at 593.

[10] If any preferential diminution of the estate occurred at all as a result of Powerine's payment of Koch, it was as a result of the indirect transfer to the bank that occurred when Powerine paid Koch and thereby extinguished the unsecured portion of the bank's liability to Koch on the letters of credit, which liability would have become an unsecured claim against the estate, had Koch drawn down the letters of credit.

As can be seen from the foregoing, the Court of Appeals focused on the wrong transfers in the wrong time frame and disregarded an essential element of a preference in applying the § 547(b)(5) test in this case. By reversing the transfers to Koch as preferential, the Court of Appeals did not replenish an estate depleted by the transfer, but increased the amount the Respondent group will receive over what they would have received had the transfer not been made—an indefensible windfall to the Respondent Committee at Koch's expense.

II.

With respect to transactions like those between Koch and Powerine, banks commonly require the customer requesting issuance of a letter of credit to provide security for the bank's assuming the contingent obligation to pay the beneficiary. In practice, the arrangement often takes the following form: the bank requires the debtor to deposit funds in the amount of the letter of credit to secure the bank's obligation on the letter. If the buyer doesn't pay the seller and the seller draws down the letter of credit, the bank reimburses itself out of the buyer's deposited funds; if the buyer does pay, the bank releases the deposited funds to cover the payment. DOLAN, THE LAW OF LETTERS OF CREDIT, ¶ 7.05; Appx.A-75 (2d Ed. 1991). That is what happened in the Koch/Powerine transaction.

Standby letters of credit play a significant role in the domestic and foreign trade. *See* DOLAN, *supra,* at ¶ 1.06; 3 WHITE & SUMMERS, UNIFORM COMMERCIAL CODE, PP-108-110 (4th Ed. 1995). Standby letters of credit not only serve to shift the credit risk from a seller such as Koch to the bank issuing the letter of credit, they also facilitate flexible pricing arrangements, as they did in this

case.[11] The decision below destroys the usefulness of standby letters of credit for these purposes, regardless of whether the obligation of the bank issuing the letter of credit is secured, unsecured or, as in the instant case, undersecured. No other instrument exists that could fill the void. *See* DOLAN, *supra,* at ¶ 2.01.

Heretofore, a buyer could assure a seller of future payment by depositing funds with a bank sufficient to cover the future payment and paying the bank a modest fee to promise the seller that when payment is due, the bank will, in effect, turn the funds over to the seller if the buyer does not pay. Such an arrangement is no longer possible following the decision of the Court of Appeals in this case.

Now, in order to protect itself from a fate like that met by Petitioner Koch in this case, a seller would have to insist that the buyer's bankruptcy be included as an event triggering its right to draw down a letter of credit, even if the petition is filed after the debtor has made payment, and that the issuing bank's obligation on the letter of credit remain in force until such time as the beneficiary can know with certainty that the payment received from the debtor cannot be taken away from it in a bankruptcy proceeding. Under these circumstances, an issuing bank (in the unlikely event it would consider

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[11] For purposes of calculating the price of the crude oil, the Powerine/Koch contracts provided that the delivery of the crude oil would be deemed to be made in equal daily quantities throughout the month of delivery, even though the crude oil was not delivered in this manner. Because price changes occurring after the actual delivery of crude oil would affect the price of the crude oil, it was impossible to determine the actual price of the crude oil until the first day of the month following delivery. (Uncontroverted Facts, ¶¶ 9, 10).

issuing a letter of credit to a buyer at all) undoubtedly would require its customer to provide additional security for this additional risk. To be safe, an issuing bank will find it necessary, not only to require its customer to "put it in funds" before paying on a letter of credit, but also to "put it in funds" out of which the bank can reimburse itself for paying a draw-down after it releases its original security in order to enable its customer to pay a creditor, lest the creditor subsequently be found to have been preferred.[12]

This would mark the end of the usefulness of the standby letter of credit in facilitating the movement of trade goods. Prior to the ruling of the Court of Appeals in this case, standby letters of credit gave creditors confidence that they would receive a nonpreferential payment, even from an insolvent debtor. Under the Court of Appeals' novel preference analysis, trade creditors can never be certain of receiving a nonpreferential payment by a debtor. This uncertainty will cause some creditors to forgo extending credit to financially weak companies, thereby hastening their slide into bankruptcy. Coupled with the knowledge that draw-downs of letters of credit are not preferential, such uncertainty also may encour-

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[12] As a practical matter, the necessity for this additional security would force abandonment of the practice of allowing the debtor to make payments out of the accounts securing a letter of credit. Consequently, a debtor making payment of a trade debt secured by a standby letter or credit would be required to keep the issuing bank in funds for a minimum of three months following making payment to the creditor. From the debtor's point of view, it would be foolish to pay rather than default under those circumstances. From the viewpoints of all three parties involved, the "standby" qualities of such arrangements would cease to exist; they would have nothing more to offer than traditional commercial letters of credit.

age creditors to assert any default, no matter how inconsequential, in order to seek payment under standby letters of credit whenever they become uncomfortable with a debtor's performance, thereby precipitating a cascade of events culminating in bankruptcy.

CONCLUSION

For the reasons stated herein, this Court should grant the writ and reverse the decision below.

Respectfully submitted,

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